

Interview by Vinson & Elkins
with Holly Reed-Falk
at footnote(s):

374

M E M O R A N D U M

April 7, 2005

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TO: Paul S. Maco
Richard C. Sauer
William E. Lawler, III

FROM: David Godschalk
Ben Lippard

RE: *City of San Diego*; Interview with Holly Reed-Falk

This memorandum summarizes the interview of Holly Reed-Falk. This memorandum does not contain a verbatim or a near-verbatim transcription of this interview, but rather is a general summary of my thoughts and impressions regarding our discussion. It is organized to summarize issues thematically and does not necessarily reproduce the order in which the interview actually occurred. There was no stenographer present at this interview, and given the nature of summarizing this type of discussion after the fact, this memorandum does not attempt to describe every statement or exchange and it is possible that there are errors in this account. It also assumes familiarity with the facts of this case, and does not provide context or explanation of every factual reference. Nor does it address issues of credibility or attempt to reconcile any differences between this interview and the accounts of other individuals.

This memorandum is subject to the attorney client and the attorney work product privileges, as it was prepared in connection with our providing legal advice to the City of San Diego (the "City") in connection with a potential SEC investigation regarding some of the matters discussed in this memorandum.

We met with Ms. Reed-Falk in her office on March 8, 2005 at approximately 9:00 a.m.

General overview of interview. Mr. Lippard began the interview by discussing the role of Vinson & Elkins ("V&E") in the investigation, the issues regarding attorney-client privilege, and stated that this memo will be provided to the SEC and the U.S. Attorney. Ms. Reed-Falk was informed that V&E did not represent any individual City employees, including her, and she stated that she participated in this interview voluntarily.

Background. Ms. Reed-Falk started at the City on May 31, 1984. She has a master's degree in accounting and is a CPA. At the City, she worked as an internal auditor for two and a half years, and on January 1, 1987, she was promoted to internal audit manager, a position she held for thirteen years. She was promoted to Payment Services Division manager on January 1,

2000. There are three sections within this division: Payroll, Accounts Payable, and Support Services. Payroll is headed by Bob Lawrence. Other key personnel in her department include Sara Jimenez, Accounts Payable; Kelli Sherman, who handles stale warrant checks; and Kay Hoey, who handles long-term debt monitoring.

Financial reporting and disclosure. Mr. Lippard asked Ms. Reed-Falk about her role in financial reporting. She stated that she prepares a schedule of long-term debt, including lists of long-term bond issues. Several years ago, she learned that this is used as a basis for a note in financial statements, although she said that previously she didn't know that table was used for that purpose. She said that under GASB 34 she also computes interest that is accrued for prior fiscal years and compiles a table of principal and interest payments due.

She stated that the errors in the footnotes relating to yield rates were not one of her areas and she did not know who compiled that. This document was circulated to a lot of people for review and comment.

Mr. Lippard questioned Ms. Reed-Falk about her role in City disclosures. She said that in regard to the TANS, she reviewed disclosures within her areas of responsibility and made comments regarding correcting paying agent language for the FY 2001 TANS. For one of these offerings, she received the general purpose financial statements, which had been passed along to bond counsel without the footnotes. In regard to land-based financings, she was responsible for reviewing documents for CFD#2 and the SEDC tax allocation bonds. For these offerings, she read the disclosure documents for those transactions and asked questions.

Environment/tone of financial reporting. Mr. Lippard asked Ms. Reed-Falk if she had an understanding of the tone from management regarding the City's reporting issues. As an example, she stated that twelve years ago in the audit division, they used to do in-house audits. During a financial statement audit of the S.D. Festivals Fund an error was found. Deloitte, then the outside auditor, was called, but did not consider it a serious issue. Joe Lazano was then consulted, as well as Ed Ryan. Mr. Ryan asked what the standards required. Ms. Reed-Falk told him they required a prior period adjustment. Mr. Ryan said that was what they would do. Ms. Reed-Falk said she was never asked to do anything incorrect or not in accordance with standards.

Ms. Reed-Falk said she was several levels removed from Mr. Ryan, although she had regular meetings with him. She never saw Mr. Ryan doing anything improper. She said Mr. Ryan even paid for his own meals - he wouldn't accept City meals. He thought it wasn't worth the risk that someone would misconstrue it.

For instance, she explained that the City Treasurer would often argue for pushing the size of the TANS offering at times when interest rates were favorable for the City; Ed Ryan quashed this proposal. Ms. Reed-Falk believes he would have adhered to that principle no matter how much the amount.

Ms. Reed-Falk also said there was no perceived change in tone from the top over time with regard to disclosure.

Quality of City reporting and disclosure. Ms. Reed-Falk said their goal was to issue financial statements in accordance with governmental standards. At the time, she felt they met

that goal. She said it looks like V&E thought the City should meet the SEC standards for disclosure. She said the City hired bond and disclosure counsel to review these areas, and thought that these professionals were good, and if these outside lawyers did not raise issues, how can non-attorneys be expected to spot them? She stated that she did not recall any discussion regarding the issue of how including CAFR elements in the OS made different standards applicable.

Ms. Reed-Falk said she has no knowledge of current problems in the City's financial statements. She said to her knowledge the past errors were largely in the footnotes. She looked at footnote 12 - Long-Term Debt - for fiscal 2003 as part of the error review process, and there were errors in how interest rates/yields were picked up.

Ms. Reed-Falk said she might have read the pension footnote also as part of that process. Ms. Reed-Falk said she supervised the 13th check audit and did the 1990 financial statement audit for CERS. She also participated in the development of the 2002 Meet & Confer (M&C) language grandfathering for purchasing service credits. She did not know who drafted it initially, and she only offered some suggestions. The issue was that some employees purchased service credits that would have placed them in excess of the 90% cap, before that cap was introduced. Ms. Reed-Falk thought that 200-300 people were affected by that issue - those who were hired before their 24th birthdays. She explained that age 24 is significant, because starting at that age, 31 years of service plus the maximum purchase of 5 years resulted in an amount greater than the cap.

In regard to the environment of her office, Ms. Reed-Falk said she always thought the office was very professional. Mr. Ryan encouraged the staff to be/become CPAs. In the past, she said, this was at the employee's own expense.

Intentional errors in financial reporting or disclosures. Mr. Lippard asked Ms. Reed-Falk if she believed any shortcomings in the City's financial reporting and disclosures were the results of intentional acts by specific individuals in the City. She said she did not believe the errors resulted from intentional acts. She said she suspected that the general lack of staffing was a problem, as it meant that there may not have been time for proper review of all issues. There was no time to think about what the accounting division was doing; they were too busy doing it. Mr. Ryan was unwilling to ask for more staff if it was general funded, although he might have if it was reimbursable. She said that Mr. Ryan was very frugal and noted that when she first started, employees were allocated one mechanical pencil for their entire career. She said the Auditor & Comptroller's Office (A&C) and Financing Services currently are pushing for more resources to comply with V&E's recommendations. She said she was never pressured to not record accounting transactions correctly or to not disclose items that she viewed to be material. Ms. Reed-Falk said she has worked for the City for 21 years and does not believe people were engaged in misconduct.

Mr. Lippard asked Ms. Reed-Falk if there was an environment or culture of not disclosing information that reflected badly on the City. She said not in her office.

Misleading of particular groups. Mr. Lippard asked Ms. Reed-Falk if she was aware of anyone at the City misleading outside legal counsel. She was not. Mr. Lippard asked if she was

aware of anyone at the City misleading the outside auditing firm. She said no and she stated that KPMG said the City was more open than most of their clients. Mr. Lippard asked Ms. Reed-Falk if she was aware of anyone at the City misleading outside rating agencies. She said she was on the TANs conference calls and did not recall any inaccurate information, and she said that on these calls, there was a high level of concern about presenting things correctly and of not wanting to open a Pandora's box by making inadvertent comments. She provided an example of where there were charges for current services provided by General Fund employees. Mr. Graciano knew for the past few years that the actual revenue (at the end of the fiscal year) for Charges for Current Services exceeded the budgeted revenue (estimated at the beginning of a fiscal year); however, budgeted numbers were typically used in preparing the cash flows. Ed Ryan fixed this issue for 2003. The budget for Charges for Current Services is prepared by Financial Management. The rating agencies asked about this issue, and were told that the General Fund departments did more work than anticipated. Ms. Reed-Falk was not sure if this was intentional, and noted that under the relevant MOUs, the enterprise funds may ask for more services from the General Fund employees.

Mr. Lippard asked Ms. Reed-Falk if she was aware of anyone at the City misleading the City Council. She said no. She noted that the City Council does not always do things in open session. She knew of no attempt to mislead the City Council, although she thought that some Manager's Reports may have understated the fiscal impact of certain proposals. She said she wasn't sure how much analysis went into that by the City departments, and that sometimes that these reports contained a "SWAG" not analysis. She did not know who writes these and how much knowledge they have. When reading these reports, if she thought more information was needed, she suggested it be put into the Manager's Report; however, the Manager's Reports may not always have enough detail for the City Council to make a good decision. Ms. Reed-Falk said all reports may not have been up to her standards, but that does not mean they were misleading.

Mr. Lippard asked Ms. Reed-Falk if she was aware of anyone at the City misleading the City Manager or the SDCERS Board. She said no.

Illegal acts. Mr. Lippard asked Ms. Reed-Falk if she had any specific knowledge of any illegal acts or violations of any laws committed by any City employees. She said she did when she was in Internal Audit between May 1984 and December 1999. She said there was no securities fraud, but there was an accounting fraud issue involving an organization that had a contract with the City submitting false invoices for payment. There was also an incident in the mid- to late- 1980's involving a payroll specialist in the Water Department who was posting overtime she did not work. This employee was prosecuted and ordered to pay restitution to the City for this overtime. The internal audit staff reported all evidence of criminal acts to the police. Ms. Reed-Falk also knew about some minor employee misconduct, such as an employee lying about having jury duty. Ms. Reed-Falk was asked if she was ever instructed by anyone in the City to commit an illegal act or violate a law with respect to the City's financial reporting and disclosure practices. She responded no.

Pension reporting/SDCERS. Mr. Lippard asked Ms. Reed-Falk if she has any understanding of the prevailing GAAP and disclosure rules for SDCERS. She replied she had no knowledge or responsibility in that area. Mr. Lippard asked Ms. Reed-Falk if she knows if anyone in the City has a good understanding of the pension accounting and disclosure rules. She

said the outside auditors who prepared the notes should know, and the accountant handling CERS should have some familiarity.

Ms. Reed-Falk was asked if she had any interaction with Caporicci & Larson or Calderon, Jaham & Osborn. She said yes while she was in Internal Audit. The Auditor/Comptroller's office had an arrangement with the outside auditors to allow its employees to participate in audits for CPA credit, and she helped coordinate that. In her current position, her interaction mostly dealt with booking conference rooms. She also handled some questions on payroll and arbitrage from Macias Gini, the audit firm for the FY 2004 financial statements. She noted that Macias Gini and KPMG had asked more questions than CJO or C&L.

Ms. Reed-Falk was asked if she relied on either of these firm for its expertise and understanding of the rules and requirements. She said she had no interaction with them, but would have expected them to have that expertise. She said she felt the same about bond and disclosure counsel – why hire them if they don't know the rules?

Shipione Allegations. We reviewed the list of allegations collected in the V&E work plan with Ms. Reed-Falk and asked if she had any personal knowledge of facts relating to those allegations. She said that she had no knowledge of facts relating to any of them, with the following exceptions.

1. With regard to the allegation that the funding deficit is due to a tortured interpretation of the Municipal Code, she said that the waterfall is in Municipal Code.

2. With regard to the allegation that the City has increased benefits without the necessary funding, she said it is correct to say that the City has increased retirement benefits and noted that the firefighter's leave proposal transferred liability from the City to the Retirement Fund, and that the benefit was not funded. She did not think there was any intent to defraud bondholders.

8. With regard to the allegation that the Corbett benefits are labeled contingent because they are paid only when earnings allow, but they do accrue.

12. With regard to the allegation that the 2002 benefit enhancements were conditioned on contribution relief, she said her understanding was that the benefits increases were contingent on CERS approval of MP2. It was part of M&C in Spring 2002. She said she participates in payroll and accounting aspects of M&C as analytical support, not in closed sessions. Regarding the MP1 trigger, she said she thought that the City would have to pay either EAN or PUC. She never heard anyone say they would have to pay enough to get funded ratio all the way to the floor; rather, the City would have to pay full ARC. She did not recall specific conversations in this regard.

15. With regard to the allegation that MP2 gives the City a false financial condition, she stated that she did not believe that to be correct, because the UAAL was disclosed.

16. With regard to the allegation that MP2 was opposed by outside experts, she said she thought fiduciary counsel opined that the Retirement Board could do this, but she is not sure where she learned that.

17. With regard to the allegation that CERS board members have conflicts of interest, she said some of the Board members are members of the system, but they only approve benefits in general. She said presidential leave comes close to being a case of them approving their own particular benefits. She said in Spring 2002 M&C that the issue had come up, which was whether incumbent, past presidents of labor unions would be allowed to use a combination of their City salary and union salary to pay benefits. She stated that she was not really involved in this issue but had heard about it. Her primary involvement in M&C that year was on the grandfathering and the mileage reimbursement issue. She never heard that presidential leave was a condition for the funding agreement, but she thought the formula increase (2.5% @ age 55 with 90% cap) was contingent. She said she never heard Ron Saathoff got presidential leave as a quid pro quo for MP2.

19. With regard to the allegation that UAAL is understated because large liabilities are not carried on the books, she said that Corbett accrues in the pension system.

28. With regard to the allegation that CERS failed to disclose the one-year lag, she said the actuary's report has the lag built in. The actuary's report is issued at the end of one fiscal year and is used for the next fiscal year. This is similar to other methodologies, such as overhead allocation, where a projection for one year is used for the next year.

33. With regard to the allegation that the City does not provide accurate payroll data, she said she was not aware of any inaccuracy in the payroll data. She said retirement contributions are set based on base compensation plus consistent add-on pay.

37. With regard to the allegation that CERS has not been audited, she said she and Judy Zellers performed an internal audit in 1990. She also said the benefit calculations, the Corbett benefits and the 13th Check have been extensively audited.

35. With regard to the allegation that CERS pays pension benefits to dead retirees, she said checks have gone out to deceased retirees, but not knowingly. She said they would never knowingly pay a dead person.

40. With regard to the allegation that private sector employees can participate in CERS if they are union presidents, she said that is correct, to the extent that their salary is less than the labor relations manager's salary.

41. With regard to the allegation that vesting is possible in 4-10 years, she said vesting is possible in five years with purchase of service credits. This was one of the changes made in 2002.

Questions relating to emails. Ms. Reed-Falk was provided copies of several emails and asked questions about them.

8/13/99 email from Terri Webster to Holly Reed-Falk and others regarding charges to error list. (Tab I) Ms. Reed-Falk said she did not recall this email. She said a list of errors was kept to show that the Auditor's office added value to the process because of errors they discovered. She said she never saw any errors that looked intentional.

8/29/03 email from Terri Webster to Lori Chapin, Rick Duvernay, cc: Holly Reed-Falk. (Tab 2) Ms. Reed-Falk said she did not know why she was copied on this. She did not recall the issue.

8/29/03 email from Cathy Lexin to Ed Ryan et al. re: Heads up. (Tab 3) Ms. Reed-Falk did not recall this document.

9/22/03 email from Alex Ruiz to Holly Reed-Falk re: Presidential Retirement Agreement. (Tab 4) Ms. Reed-Falk recalled this document and stated that Mr. Saathoff did a purchase of service, which was calculated based on his City salary. The Auditor's office felt that since he was going to be able to use part of his union salary, he should purchase service on that basis as well, which would increase the cost. Ms. Reed-Falk did not think it was smart for Retirement to calculate the cost based on the City salary alone, which would increase liability. She is not sure why CERS calculated it that way, but it may have been done prior to the Presidential Leave, and she did not know if the Auditor's office had ever raised the issue with CERS. She was copied on this document because she had been in the internal audit function for a long time, and was perceived by many to have useful knowledge as a result; she was not formally part of this process.

Presidential Retirement Agreement. (Tab 5) Ms. Reed-Falk stated that this agreement was retroactive to July 1 and she said that she thinks that the cost was paid later. There should have been a higher salary since the Presidential Benefit had been approved before the agreement was executed. Ms. Reed-Falk was not sure of the current status of this issue. When asked why Mr. Saathoff got such a good deal, Ms. Reed-Falk stated that he is very good at presenting his arguments and is eminently believable to people that are not familiar with all the details of a given issue; she thought he is an exceptional salesman. Ms. Reed-Falk stated that Ms. Lexin would sometimes call her to ask about suggestions made by Mr. Saathoff, specifically to ask what he might not be telling her. Ms. Reed-Falk did not know if Mr. Saathoff was deceiving anyone on this issue, but she did not know what the City's motive to approve this deal would be. Ms. Reed-Falk stated that Dan Kelley, now with San Diego County, would be a good person to talk to about this issue.

10/15/03 email from Terri Webster to Bob Lawrence re tax id. (Tab 6) Ms. Reed-Falk remembered this document, and stated that CERS wanted a tax ID number because of some issue involving foreign investment – the securities were held in the name of CERS, but in the City's tax ID number, which caused confusion. Ms. Reed-Falk was in the loop on this issue because of the pension payroll issues – there can't be two tax ID numbers used. CERS received its own tax ID number on January 1, 2005. Ms. Reed-Falk stated that Ms. Webster was concerned about CERS's efforts to be totally separate from the City. Legislation in the 1990s had stopped the state from raiding CERS funds, and CERS was trying to use that decision to make itself totally independent from the City. This was a big issue in the late 1990's, but Ms. Reed-Falk was not sure why.

11/7/03 email from Terri Webster to Holly Reed-Falk et al. re: Info provided for our review. (Tab 7) Ms. Reed-Falk recognized this email. The Rural/Metro Corporation is an Arizona corporation that partnered with the City Fire Department to provide paramedic services to the City, though an entity called SDMSE, LLC. The information in the 10-K for Rural/Metro

was not flattering, and raised concerns about whether it was viable as a going concern, and there was an issue about whether this information needed to be in the City's financial statements due to SDMSE. Ms. Reed-Falk was involved in this issue because she had a lot of history with the paramedic contract, and she may have been sent this email for CYA purposes. Ms. Reed-Falk did not know how this issue was ultimately resolved.

11/19/03 email from Paul Barnett to Terri Webster re: Contribution Spreadsheet is attached. (Tab 8) Ms. Reed-Falk did not recall this issue, but stated that she was not unfamiliar with the issue. While Cecelia San Pedro was out on maternity leave, Ms. Reed-Falk had been helping Terri Webster with retirement issues, such as running numbers for the portion of employee offset paid out of CERS reserves and calculating when those reserves would run out. She thought Bob Wilson might remember off the top of his head when a portion of the retirement offset began being paid out of the reserve. Ms. Reed-Falk stated that she was probably asked to do this because the Accounting Division was very busy. Ms. Reed-Falk characterized Ms. Webster as a very ethical person, and stated that she had never encountered someone in the City committing any intentional wrongdoing or illegal acts.

11/24/03 email from Jeanne Cole to Holly Reed-Falk re: Revised Pension Footnote. (Tab 9) Ms. Reed-Falk stated that she may have performed a "cold review" of this footnote, but did not recall any specific comments she might have had.

12/16/03 email from Terri Webster to Holly Reed-Falk re: Death Match Audit. (Tab 10) Ms. Reed-Falk did not know what "not looking good" meant, and stated that she knew that Diann Shipione had been asking questions about this issue but was not sure what she was focused on.

12/16/03 email from Diann Shipione Shea to Paul Barnett re: Death Match Audit. (Tab 11) Ms. Reed-Falk stated that Ms. Shipione was invited to review information regarding this issue, but did not show up to do so. Ms. Reed-Falk explained that she had performed some of the internal audit regarding this issue and had found no intentional misconduct. To the best of her recollection, the retirement system used state records to identify dead retirees in the 1980's and then later used a national database. The City Auditor's office found only one person who was deceased that CERS had not found.

Undated email fragment, Lisa Foster to Diann Shipione. (Tab 12) Ms. Reed-Falk was not sure why the decision had been made to treat Diann Shipione as a member of the general public with regard to these records.

1/12/04 email from Loraine Chapin to Lawrence Grissom et al. re: waterfall born. (Tab 13) Ms. Reed-Falk stated that she was involved in this issue because Ms. San Pedro was on maternity leave. She had read something in the Municipal Code and looked it up, and she asked her clerk to pull a copy. Ms. Reed-Falk stated that this issue may be related to the Port district, as Terri Webster was looking into an issue regarding whether the Port district was paying its share of administrative expenses twice, once through the Waterfall, and once through billing. Ms. Webster had gone to the Board to try to figure out this issue, once she learned of the error. Ms. Reed-Falk thought that the ordinance reflected in this email may have talked about payment of administrative costs, and Ms. Chapin later sent a detailed email on this issue.

1/14/04 email from Terri Webster to Gary Caporicci et al. re: FY03 CERS CAFR. (Tab 14) Ms. Reed-Falk stated that this mistake was made by Michelle Lawrence, an Accountant III responsible for pension payroll and who worked for Ms. Reed-Falk. She stated that this error was not intentional and was corrected. She was not sure how the error had occurred, but thinks it might have come from an error in a spreadsheet formula.

2/8/04 email from Terri Webster to Holly Reed-Falk et al. (Tab 15) Ms. Reed-Falk stated that she knows that Paul Webber was asking a lot of questions, prompted by allegations made by Diann Shipione. She thinks he was looking at issues in very microscopic detail, but she was not directly involved in this. Ms. Reed-Falk knew that some people were frustrated with Mr. Webber, who thought that his disclosure proposals were overkill. This view was based on the past advice of bond counsel, who had thought things were fine in the past. Some at the City thought that Mr. Webber might be trying to cover himself, as his firm had done some of this past work. Ms. Reed-Falk never heard anyone saying that the City should not disclose these issues, because it needed to get bonds sold. The City had never experienced this kind of situation with its bond counsel. Ms. Reed-Falk stated that she never got the sense that people were not giving information or trying to hide things, nor was she aware of Mr. Webber not getting the information he asked for. She noted that people put a lot of time and effort into responding to Mr. Webber.

Wrap up questions. Ms. Reed-Falk was not aware of any misconduct or illegal conduct in the areas of financial reporting, accounting, pension benefits, health care benefits, disclosure or any other area. She agreed to inform us if she recalled anything additional about the topics covered during the interview. She also noted that the City Attorney's office had been unclear in the guidance it gave her regarding compliance with recent subpoenas from the U.S. Attorney's Office.